

# HOUSE BILL REPORT

## SHB 1257

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### As Passed Legislature

**Title:** An act relating to adopting the investments of insurers model act.

**Brief Description:** Adopting the investments of insurers model act.

**Sponsors:** House Committee on Business & Financial Services (originally sponsored by Representatives Stanford, Kirby and Kelley; by request of Insurance Commissioner).

#### **Brief History:**

##### **Committee Activity:**

Business & Financial Services: 1/21/11, 1/25/11 [DPS].

##### **Floor Activity:**

Passed House: 3/5/11, 98-0.

Senate Amended.

Passed Senate: 4/11/11, 47-0.

House Concurred.

Passed House: 4/14/11, 97-0.

Passed Legislature.

#### **Brief Summary of Substitute Bill**

- Repeals the existing provisions for the regulation of insurer investments.
- Creates a new regulatory framework to regulate insurer investments.

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### HOUSE COMMITTEE ON BUSINESS & FINANCIAL SERVICES

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 13 members: Representatives Kirby, Chair; Kelley, Vice Chair; Bailey, Ranking Minority Member; Buys, Assistant Ranking Minority Member; Blake, Condotta, Hudgins, Hurst, Parker, Pedersen, Rivers, Ryu and Stanford.

**Staff:** Jon Hedegard (786-7127).

#### **Background:**

[General Background on Financial Regulation of Insurers.](#)

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*This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.*

*Capital and Surplus Requirements.* Insurers are required to have minimum amounts of capital and surplus to transact business in Washington. The amounts vary based on which type or types of insurance the insurer is licensed to sell.

*Risk-based Capital.* This tool is used to determine if an insurer has enough assets in relation to the risk it holds. There is a complicated series of algorithms used to determine a ratio. If the insurer does not meet threshold ratios, the Insurance Commissioner (Commissioner) can take prescribed actions. The types of actions range from requiring more reports to liquidation.

*National Association of Insurance Commissioners (NAIC) Standards.* As a general rule, the financial and accounting standards used by insurance regulators are uniform standards developed by the NAIC. The NAIC periodically reviews the financial regulatory structures of the states to determine if they meet minimum thresholds. If a state meets the appropriate standards, it is "accredited" and other states know they can rely on the examinations of that state. If it is not accredited, other states may choose to conduct more thorough exams of the companies domiciled in that state. This increases the costs for the other states and for the examined insurers.

*Quarterly and Annual Report.* Every insurer must submit specific financial records to the NAIC and the Office of the Insurance Commissioner (OIC) every quarter and each year. These are public records.

*Financial Exams.* At least once every five years, the OIC is required to conduct a financial examination of an insurer domiciled in the state. Insurers must provide all records to the examiners and pay for the examination.

#### Regulation of Investments.

The NAIC has two different model acts to regulate insurers and investments. Investment models are not currently included as a part of the accreditation process.

The first model, the "defined limits" model, restricts the specific level of investments by insurers in certain areas. The second model, the "defined standards" model, provides more flexibility for insurers but provides more guidance and principles for investment. In the defined standards model, restrictions on investments are applied to make sure the insurer meets minimum financial standards. After the threshold standards are met, an insurer has more flexibility to invest according to the insurer's principles and policies.

*State Investment Standards.* The state's regulatory framework regarding insurer investments predates the current NAIC models. Insurer investments are limited to certain specific levels of investment classes so it uses more of a defined limit approach as the base for oversight. The investment standards apply to domestic insurers but there is also a provision requiring insurers formed in another state or country to have investments of "a quality substantially as high as those required" for domestic insurers.

*Transactions Authorized by Board or Committee.* Every investment, loan, sale, or exchange made by any domestic insurer must be authorized or approved by its board of directors (board) or by a committee that is charged with the duty of making the investment, loan, sale,

or exchange. The minutes of any such committee must be recorded and reports submitted to the board for approval or disapproval. The only exception is for policy loans of a life insurer.

*Limits on Investments.* There are prescribed limits for aggregate investments in:

- cash;
- bonds;
- real property held as a home office;
- real property investments;
- mortgages;
- equities and preferred equities;
- foreign investments;
- loans on policies; and
- other investments.

Some investments are not recognized in the existing law or are not allowed by current law. For example, an insurer may not invest in mutual funds or in several types of foreign investment, including currencies, loans, and real property.

*Prohibited Investments.* Unless approved by the Commissioner in advance, an insurer must not invest in or hold:

- issued shares of its own capital stock, except for the purpose of mutualization;
- securities issued by any corporation if a majority of its stock having voting power is owned by or for the benefit of any one or more of the insurer's officers and directors;
- any investment or loan not authorized by state law or in excess of the allowed limits;
- securities issued by any insolvent corporation;
- obligations that do not meet standards regarding medium grade or lower investments;
- or
- any investment or security which is found by the Commissioner to be designed to evade any prohibition of this code.

An insurer may demand a hearing regarding any act, threatened act, or failure of the Commissioner to act. This includes determinations regarding investments and actions or inactions based on those determinations.

### **Summary of Substitute Bill:**

The existing provisions for the regulation of insurer investments are repealed. A new regulatory structure for insurer investments is created to apply to: domestic insurers; United States branches of alien insurers entered through this state; alien insurers admitted and using this state as their port of entry; domestic fraternal benefit societies; domestic health care service contractors; domestic health maintenance organizations; and domestic self-funded multiple employer welfare arrangements.

The new oversight provisions establish minimum financial security benchmarks and asset standards for insurers. Insurers may not exceed specified aggregate investments in meeting their minimum financial security benchmarks. After the threshold benchmarks are met, insurers may invest beyond the specified aggregate limits.

### Minimum Financial Security Benchmark.

The minimum financial security benchmark for an insurer is the greater of:

- the authorized control level risk-based capital applicable to the insurer in current statutes; or
- the minimum capital or minimum surplus required for the maintenance of an insurer's ability to transact business.

The Commissioner may order a minimum financial security benchmark to apply to a specific insurer provided it is not less than a specified amount. The Commissioner must determine the amount of surplus that constitutes an insurer's minimum financial security benchmark, as an amount that will provide reasonable security against contingencies affecting the insurer's financial position that are not fully covered by reserves or by reinsurance. There are a host of contingencies and factors that must be considered by the Commissioner in making a determination. The Commissioner may adopt a minimum financial security benchmark by rule that is a multiple of authorized control level risk-based capital to apply to any class of insurers. The benchmark for a class must not be less than the amounts currently required by statute under specified conditions.

The minimum asset requirement is the the sum of an insurer's liabilities and its minimum financial security benchmark. Invested assets may be counted toward the minimum investment requirement, only so far as the investments comply with the statutes, any rules adopted, and orders issued by the Commissioner. An investment that qualified as an admitted asset prior to the effective date of the bill remains qualified as an admitted asset. If an insurer does not own and cannot apply an amount of assets equal to its minimum asset requirement, the Commissioner may deem it to be financially hazardous.

### Investments.

An insurer may loan or invest its funds, and may buy, sell, hold title to, possess, occupy, pledge, convey, manage, protect, insure, and deal with its investments, property, and other assets.

### Reasonable Prudence Standard.

In making investments for an insurer, the board must exercise the judgment and care that persons of reasonable prudence, discretion, and intelligence regarding the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital. Investments must be of sufficient value, liquidity, and diversity to assure the insurer's ability to meet its outstanding obligations based on reasonable assumptions. The insurer must establish and implement internal controls and procedures to assure compliance with investment policies and procedures.

A number of specific factors must be evaluated by the insurer and considered along with its business in determining whether an investment portfolio or investment policy is prudent. The Commissioner must consider the same factors prior to making a determination that an insurer's investment portfolio or investment policy is not prudent.

### Written Investment Policy.

An insurer must establish and follow a written investment policy. The policy must be reviewed and approved by the insurer's board at least annually. The policy must include specific written guidelines appropriate to the insurer's business.

#### Limits on Investments.

There are standards or prescribed limits for aggregate investments in:

- cash;
- bonds;
- real property held as a home office;
- real property investments;
- mortgages;
- equities, preferred equities, and mutual funds;
- investments in foreign currencies, loans, property, bonds, and equities;
- loans on policies; and
- other investments.

#### Prohibited Investments.

An insurer must not invest in:

- the use of a derivative instrument for replication, speculative, or for any purposes other than hedging or income generation;
- real property for speculative, ranching, farming, mining, gaming, amusement, oil, gas, or mineral exploration, or club purposes;
- issued shares of its own capital stock, held directly or indirectly, except for the purpose of mutualization;
- securities issued by any corporation if a majority of its stock having voting power is owned directly or indirectly by or for the benefit of any one or more of the insurer's officers and directors;
- securities issued by any insolvent corporation;
- any instrument or security which is found by the Commissioner to be designed to evade any limitation or prohibition of the Insurance Code; and
- other investments prohibited by rule.

A reasonable time must be allowed for disposal of a prohibited investment if:

- the investment is demonstrated by the insurer to have been legal when made;
- the investment is the result of a mistake made in good faith; or
- the Commissioner deems that a sale of the asset is contrary to the interests of insureds, creditors, or the general public.

#### Reports to the Commissioner.

The Commissioner may require any of the following:

- statements, reports, answers to questionnaires, and other information;
- an explanation of any data storage or communication system in use; and
- production of information from any books, records, data systems, computers, or any other information storage system at a reasonable time and in a reasonable manner.

An insurer or specified person must reply within 15 business days to a written inquiry from the Commissioner. Failure to make a timely response is a violation. The Commissioner may

require verification of any communication made to the Commissioner. The Commissioner may bring suit against any person that provided information that is not truthful and accurate.

#### Commissioner's Powers.

If the Commissioner determines that an insurer's investment practices do not meet the statutory requirements, the Commissioner may order the insurer to make the necessary changes. The Commissioner may impose reasonable additional restrictions upon the admissibility or valuation of investments or may impose restrictions on the investment practices of an insurer, including prohibition or divestment if the Commissioner determines that the financial condition of an insurer is or may endanger:

- a current investment practice or plan of an insurer; or
- the interests of insureds, creditors, or the general public.

The Commissioner may count assets in which an insurer is required to invest under the laws of a foreign country as a condition for doing business in that country toward the satisfaction of the minimum asset requirement.

If the Commissioner is satisfied with the financial stability of an insurer and the competence of management, the Commissioner may:

- adjust the class limitations for that insurer. Adjustments are limited to an amount equal to 10 percent of the insurer's liabilities; or
- exempt the insurer from specific restrictions to the extent that the Commissioner is satisfied that the interests of insureds, creditors, and the general public are protected.

#### Commissioner Staff.

The Commissioner may retain expert staff at the insurer's expense as is reasonably necessary to assist in reviewing the insurer's investments.

#### Insurer's Right to a Hearing.

An insurer aggrieved by an order or any other act or failure to act of the Commissioner may request a hearing.

#### Confidentiality of the Investment Policy.

The investment policy and information related to the investment policy provided to the Commissioner for review is confidential and is not a public record or subject to subpoena.

#### Rules.

The Commissioner may adopt rules interpreting and implementing the provisions of the act. The Commissioner has specific authority to adopt rules regarding certain investment restrictions.

#### Report.

By December 1, 2011, the Commissioner must submit a report to the Governor and to the appropriate committees of the Legislature. The report must include the following information:

- the estimated total dollar amount of insurer assets affected by the act;
- an analysis of the statutory changes in investment regulation made by the act and the reasons for the changes;

- an analysis of any risks to policyholders and taxpayers associated with the implementation of the act and any provisions in the act that protect against those risks;
- any proposed rules to implement the act;
- any changes to staffing in the OIC related to implementing the act;
- an explanation describing why the investment policy an insurer must be exempt from public disclosure and subpoena;
- a list of other states that have adopted all or part of the NAIC model legislation on insurer investments and the reasons for their decisions; and
- a list of states that have explicitly chosen not to adopt the NAIC model legislation and the reasons for their decisions.

In preparing the report, the Commissioner must consult with the Department of Financial Institutions and the Washington State Investment Board.

**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill takes effect on July 1, 2012.

**Staff Summary of Public Testimony:**

(In support) This is an agency-request bill to update the current statutory structure regarding insurer investments. The goal is to increase financial solvency and to provide more flexibility for insurers to manage their investments. This bill is an improvement over the existing insurer investment standards. The original chapter regulating insurer investments was adopted in 1947. The new regulatory standards encourage investment diversification. Today it is understood that diversification is the best way to decrease investment risk. There are minimum standards that must be met. After the standards are met, then insurers are given the flexibility to use their expertise to make investments. The OIC worked with stakeholders in a long, intense, and involved process to develop the bill. The result is a set of standards that are an improvement over the existing law.

(Opposed) None.

**Persons Testifying:** Representative Stanford, prime sponsor; Drew Bouton and Jim Odiorne, Washington State Office of the Insurance Commissioner; and Jean Leonard, Washington Insurers.

**Persons Signed In To Testify But Not Testifying:** None.